Congress of the United States
U.S. House of Representatives
Committee on Small Business

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To:	Members, House Small Business Committee, Subcommittee on Investigations, Oversight and Regulations
From:	Andy Guggenheim, Counsel
Subject:	Subcommittee Hearing: "Open for Business: The Impact of the CFPB on Small Business"
Date:	July 26, 2011

On Thursday July 28, 2011, at 1:30 pm in Room 2360 of the Rayburn House Office Building, the Subcommittee on Investigations, Oversight and Regulations of the Committee on Small Business will meet for the purposes of reviewing the impact of regulations on small business. The hearing will focus on the new Consumer Financial Protection Bureau created by the Dodd-Frank Wall Street Reform and Consumer Protection Act. Witnesses at the hearing will represent the Consumer Financial Protection Bureau, the financial services industry and small business.

Financial Crisis

In 2007 and 2008, the massive gains experienced in the housing market as a result high demand for real estate began to dissipate. As housing prices fell, borrowers who bought homes anticipating that prices would continue to increase found themselves unable to afford their homes, forcing banks to foreclose. The widespread foreclosures led to a further depression in home prices creating a vicious cycle of default and foreclosure. The aftermath of increase in foreclosures was not limited to the housing industry since mortgage lenders at the local level sold mortgages to free-up additional capital to lend to more homebuyers. The mortgages were later packaged into securities consisting of hundreds of mortgages and sold by Wall Street firms to investors. These securities gave the investor rights to the payment from the homeowner. A result of the willingness of third parties to purchase mortgage loans, underwriting standards diminished to the point that banks were no longer verifying the income of borrowers or other safeguards to ensure that borrowers were able to repay their loan. The lack of effective underwriting lead to less credit worthy borrowers being offered mortgages loans that they could unlikely afford without continued increases in home values.

Beginning in the 1980's, banks began offering mortgages to people who traditionally were not able to qualify for a mortgage loans.[1] The mortgage products being offered included lower down payments and higher interest rates to make up for the increased credit risk. Besides higher interest rates, many subprime mortgages also included lower introductory rates that would increase dramatically during the life of the loan, balloon payments or higher closing costs. Consumer advocates believe that mortgage products that push fees into the future have a greater chance to deceive consumers since the higher fees are pushed into the future.[2] Despite the higher rates, many borrowers entered into these agreements because they offered the opportunity to not only own a home, but to build equity in that home.[3]

The proliferation of subprime mortgages by both bank and nonbank entities was left unchecked by federal regulators responsible for oversight.[4] On the banking side, jurisdiction for mortgage practices was left the bank's primary regulator who was also responsible for the safety and soundness of the covered institution. For non-bank mortgage lenders, there was confusion among federal regulators about whether they had the authority to take action against abusive practices.[5] According to the Department of the Treasury, the financial crisis was caused in-part by "pervasive failures in consumer protection."[6] Treasury's justification for this assessment is that the government could have done more to prevent mortgage products from being offered to consumers who did not understand and could not afford the obligations they were entering into.

The increase in foreclosures was one of many elements leading to a near collapse of banking system that resulted in the loss of close to $11 trillion in household wealth and approximately four million families losing their homes.[7] Inadequate capital reserves and excessive risk taking among other factors by financial firms led to a loss of confidence between banks causing credit to essentially freeze. Many financial firms were either closed because of the inability to raise private capital, were sold to competitors at bargain basement prices, or were forced to accept assistance from the federal government.[8]

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[1] *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, at 68, available at: http://www.gpoaccess.gov/fcic/fcic.pdf.
[2] Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. Pa. L. Rev. 1, 53 (2008).
[3] *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, at 70, available at: http://www.gpoaccess.gov/fcic/fcic.pdf.
[4] At its peak in 2006, subprime mortgages made up 23.6 percent of the market.
[5] *Id. at 76.*
[6] Department of the Treasury *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation*, at. 3.
[7] [7] *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, available at: http://www.gpoaccess.gov/fcic/fcic.pdf.
[8] *Id at. 353.*

The Dodd-Frank Act

In the beginning of the 111th Congress, began to look at legislative responses to response to the financial crisis. The ultimate result of this effort was the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act),[9] which was signed into law by the President on July 21, 2010. This law responds to the causes of the financial crisis by creating a regulatory structure for previously unregulated financial products.

The Dodd-Frank Act charges government regulators with oversight of systemic risk in the financial system by creating the Financial Stability Oversight Council (FSOC). The FSOC is composed of ten voting and five nonvoting members.[10] To prevent an ad hoc system of bailouts, the Act creates an orderly liquidation process for the failure of institutions deemed by the FSOC to create systemic risk to the financial system.

The Dodd-Frank Act also streamlines the federal bank regulatory structure by eliminating the Office of Thrift Supervision, and transferring its authority to the Office of the Comptroller of the Currency, the Federal Reserve and the Federal Deposit Insurance Corporation. The Act also brings the insurance industry under federal supervision by creating the Office of National Insurance. This office is responsible for monitoring the insurance industry to identify gaps in regulation that might contribute to systemic risk.[11]

To strengthen regulation of banks holding companies and depository institutions, changes are made to the organizational structure of bank holding companies. New requirements are placed on transactions between insiders at depository institutions, capital reserves and merger and acquisition activity. The "Volker Rule" is also imposed which prohibits a banking entity from engaging in proprietary trading, or from investing in a hedge fund or private equity fund.[12] Also, for the first time, the Act provides for regulation of swaps. A swap is a way for companies to hedge against rising prices by entering into contracts for the future purchase of a good. Further, the Act provides for regulation of swaps by creating a regulated system for payment, clearing and settlement of swap contracts.

To protect investors, Dodd-Frank provides new requirements for investment advisors, credit rating agencies and entities required to register with the Securities and Exchange Commission. In addition, the Act imposes executive compensation requirements, prohibitions on certain

[9] Pub. L. No. 111-203.
[10] The 10 voting members include the Treasury Secretary (who will chair the FSOC), the Chairman of the Federal Reserve Board, the Comptroller of the Currency, the Director of the Bureau, the Chair of the Securities and Exchange Commission, the Chair of the FDIC, the Chair of the Commodity Futures Trading Commission, the Director of the Federal Housing Finance Agency, the Chair of the National Credit Union Association Board, and an independent member appointed by the President and confirmed by the Senate with insurance expertise.
[11] Pub. L. No. 111-203 § 311.
[12] Pub. L. No. 111-203 § 619.

business practices by credit ratings agencies and enhanced disclosure requirements. The law also addresses the lack of regulatory focus on consumer transactions by creating the Consumer Financial Protection Bureau.

Consumer Financial Protection Bureau

The Consumer Financial Protection Bureau (CFPB) is an independent bureau established within the Federal Reserve responsible for enforcement of consumer protection laws that were previously enforced by a collection[13] of federal agencies.[14] Despite being housed within the Federal Reserve, the Federal Reserve Board of Governors is expressly prohibited from intervening in any administrative, examination, or enforcement matter being taken by the CFPB.[15] The Bureau is headed by a director to be named by the President, [16] subject to the advice and consent of the Senate for a term of five years.[17]

To set-up the new Agency, the President chose Elizabeth Warren who helped create the Consumer Financial Protection Bureau. To date, the new bureau has organized into six divisions and hired over 200 full-time staff.[18] The Bureau will be broken into:

- The Division of Consumer Engagement and Education responsible for providing information to consumers about financial products;
- the Division of Supervision, Fair Lending and Enforcement responsible for enforcing federal consumer financial laws;
- the Division of Research, Markets and Regulation responsible for determining whether additional regulation is needed and performing regulatory cost-benefit analysis;
- the Office of General Counsel to provide legal advice to the Bureau;
- External Affairs responsible for outreach to stakeholders; and
- the Chief Operating Officer responsible for internal management of the Bureau.

The CFPB has the statutory authority to review regulatory reports issued by other banking regulators, as well as enforce and promulgate regulations under existing consumer protection laws. Specifically, "[t]he Bureau shall seek to implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to the markets for consumer financial products and services and that markets for consumer financial

[13] The federal agencies required to transfer consumer protection functions include: The Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation, the Federal Trade Commission, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Department of Housing and Urban Development.
[14] Pub. L. No. 111-203 § 1011(a).
[15] Pub. L. No. 111-203 § 1012.
[16] On July 18, 2011 President Obama announced the nomination of Richard Cordray to be Director of CFPB.
[17] Pub. L. No. 111-203 § 1011(b).
[18] *Building the CFPB: A Progress Report*, available at. http://www.consumerfinance.gov/wp-content/uploads/2011/07/Report_BuildingTheCfpb1.pdf.

products and services are fair, transparent, and competitive."[19] While the true scope of the CFPB is yet to be known, the Dodd-Frank Act appears to give the Bureau authority over an array of consumer financial products and services, including deposit taking, mortgages, credit cards and other extensions of credit, loan servicing, check guaranteeing, collection of consumer report data, debt collection, real estate settlement, money transmitting, financial data processing, and others. To protect consumers, the CFPB has the authority to limit "unfair, deceptive and abusive" business practices.[20]

To consolidate consumer protection into one agency, the CFPB is given broad regulatory authority over consumer protection laws currently being enforced by other federal agencies. On July 21, 2011, CFPB published the final list of rules and orders that will be enforced by the Bureau.[21] This list covers the transfer of nine regulations previously enforced by the Board of Governors of the Federal Reserve, three regulations from the Federal Deposit Insurance Corporation, four regulations from the Office of the Comptroller of the Currency, five regulations from the Office of Thrift Supervision, six regulations from the National Credit Union Administration, fourteen regulations from the Federal Trade Commission, and eight regulations from the Department of Housing and Urban Development.

In addition to the regulation of banks and thrifts, Dodd-Frank also gives CFPB the authority to regulate residential mortgage, private education lending and payday lending markets. On June 23, 2011 the CFPB issued a request for public comment seeking suggestions on how the Bureau should define "larger participants" for non-bank consumer protection purposes.[22] Further, depending on the ultimate definition adopted by CFPB, the entities covered by this rule might in fact be small businesses as well as impacting alternative funding sources.

Despite the broad jurisdiction of the Bureau in the area of consumer protection, there are statutory limits on its authority with respect to smaller financial institutions. Section 1026 of Dodd-Frank exempts depository institutions and credit unions with under $10 billion in assets from primary examination and enforcement by the CFPB. The institution's primary regulator retains authority to oversee the institution without interference from the CFPB. Despite this exemption, institutions under $10 billion must still comply with all generally applicable CFPB regulations including consumer protection and reporting requirements. In testimony before the House Financial Services Subcommittee on Financial Institutions and Consumer Credit, representatives from exempted entities expressed concerns that the exemption did not go far enough to minimize the regulatory burdens on smaller institutions. First, many smaller entities

[19] Pub. L. No. 111-203 § 1021(a).
[20] Pub. L. No. 111-203 § 1023.
[21] 76 Fed. Reg. 43569 (July 21, 2011).
[22] *Defining Larger Participants in Certain Consumer Financial Products and Services Markets*, Bureau of Consumer Financial Protection, 76 Fed. Reg. 38059 (June 29, 2011).

are concerned that the $10 billion exemption is not indexed for inflation.[23] By not indexing the exemption for inflation, many more entities can potentially come under the jurisdiction of the CFPB. Second, businesses are concerned about the ability of CFPB to join primary regulators as passive observers during examinations.[24] Although limited, CFPB may still require reports from depository institutions and credit unions on compliance with federal consumer financial law and conduct reviews "on a sampling basis" on examinations performed by primary regulators.[25] Although they have the ability to review reports for compliance with Federal consumer financial law, it remains the responsibility of the entities' primary regulator to take enforcement action.

In addition, there are several consumer transactions that the Bureau is expressly prohibited from regulating the following transactions.[26]

Merchant, retailers or sellers of nonfinancial goods or services	Licensed real estate agent or broker
Agents or brokers for manufactured or modular homes	Certified public accountant or tax preparer
Licensed attorney's engaged in the practice of law	Persons regulated by a state insurance regulator
Persons regulated by a state securities commission	Persons regulated by the Commodity Futures Trading Commission
Person regulated by the Farm Credit Administration	Persons engaged in the solicitation of voluntary contributions to a tax exempt charity
Motor vehicle dealers engaged in the sale, lease and servicing of a motor vehicle[27]	

Section 1071 of the Dodd-Frank Act requires persons offering credit to inquire whether the business is women-owned or minority-owned and report that information to the CFPB. In addition to the threshold question of ownership, the reporting must also include information about the amount of the loan application, demographic information about the applicant and the ultimate credit decision. The CFPB is given regulatory authority to prescribe rules for compliance with this new reporting requirement. Currently, the only data available on small

[23] *Legislative Proposals to Improve the Consumer Financial Protection Bureau: Hearing before the House Financial Services Committee Subcommittee on Financial Institutions and Consumer Credit* (April 6, 2011) (Testimony of Rod Staatz, President and Chief Executive Officer SECU of Maryland, on behalf of the Credit Union National Association).
[24] *Legislative Proposals to Improve the Consumer Financial Protection Bureau: Hearing before the House Financial Services Committee Subcommittee on Financial Institutions and Consumer Credit,* (April 6, 2011) (Testimony of Noah Wilcox President and CEO of Grand Rapids State Bank Grand Rapids, MN, on behalf of the Independent Community Bankers of America).
[25] Pub. L. No. 111-203 § 1026.
[26] Pub. L. No. 111-203 § 1027
[27] Pub. L. No. 111-203 § 1029

business lending comes from Federal Deposit Insurance Corporation Report of Condition and Income, commonly referred to as the Call Report. This data, is reported quarterly by regulated financial institutions and includes the institution's balance sheet and income statement. This data includes information about small loans, but these reports do not provide information about lending to small business since a small business may receive a large loan, or a large business may receive a small loan.

This new reporting requirement was supposed to take effect on July 21, 2011 when the regulatory powers were transferred to the new agency.[28] However, according to an April 16, 2011 memorandum issued by CFPB General Counsel Leonard Kennedy, the reporting requirements do not go into effect until CFPB issues implementing regulations.[29] In addition to the delay in the data collection requirements, Mr. Kennedy states that data collection "[i]s an important tool that will significantly bolster both fair lending oversight and a broader understanding of the credit needs of small businesses." Despite this pronouncement, many covered institutions have noted that the mere collection of data will create new compliance burdens while providing little meaningful information on small business lending trends.[30]

Given the scope of the CFPB's rulemaking authority, this new agency has the potential to impose significant burdens on small institutions. According to the Small Business Administration Office of Advocacy, small businesses face 36 percent higher regulatory compliance costs than large business.[31] To minimize the burden of consumer regulations on small business, Dodd-Frank requires regulations issued by the Bureau be subject to the review process found in the Small Business Regulatory Enforcement Fairness Act (SBREFA). SBREFA creates a procedure to help agencies[32] minimize the regulatory burden on small businesses by requiring that rules that impact small businesses go through Small Business Advocacy Review (SBAR) panels. These panels are made-up of small business representatives whose members are responsible for meeting and suggesting alternative proposals that are less burdensome on small business.[33]

By seeking the input of small business representatives prior to issuance of proposed rules, the law attempts to minimize the compliance burdens on small firms. However, as hearings before the Small Business Committee have showcased, compliance with SBREFA by agencies has been

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[28] Pub. L. No. 111.203 § 1071(d)

[29] Letter from CFPH General Counsel Leonard J. Kennedy to Chief Executive Officers of Financial Institutions under Section 1071 of the Dodd-Frank Act, available at: http://www.consumerfinance.gov/wp-content/uploads/2011/04/GC-letter-re-1071.pdf (April 11, 2011).

[30] Credit decisions usually involve a variety of factors besides the size of the business including credit scores of ownership, collateral value, product mix and market demographics.

[31],Nicole Crain and Mark Crain, *The Impact of Regulatory Costs on Small Firms*, U.S. Small Business Administration, Office of Advocacy, (2010).

[32] The Environmental Protection Agency (EPA) and the Occupational Safety and Health Administration (OSHA) were the two agencies subject to the SBREFA process besides the CFPB.

[33] For an in-depth discussion of the SBREFA process, See. *Lifting the Weight of Regulations: Growing Jobs by Reducing Regulatory Burdens*, House Small Business Committee. (June, 16, 2011).

inadequate, resulting in unnecessary compliance burdens on small business. It remains to be seen whether subjecting the CFPB to the SBREFA panel requirement will achieve the congressionally stated purpose of minimizing the regulatory burden on small business.

Another protection in the law to ensure that the Bureau does not issue regulations with an adverse impact on the banking industry is the requirement to clear all regulations through the Financial Stability Oversight Council (FSOC). FSOC may stay or set aside any regulation it deems to jeopardize the safety and soundness of the banking system or the financial system of the United States.[34] To stay or set aside a regulation, the Act requires a 2/3 vote of the FSOC. On Thursday July 21, 2011, the House of Representatives passed H.R. 1315 the Consumer Financial Protection Safety and Soundness Improvement Act of 2011.[35] This bill made several changes to the regulatory review authority of the FSOC including, changing the standard or review to any rule that "is inconsistent with the safe and sound operations of United States financial institutions" from a regulation or provision that would put the safety and soundness of the United States banking system, or the stability of the financial system of the United States at risk.[36] Further, the legislation changes the voting threshold from a 2/3rds vote of the FSOC to a simple majority excluding the Director of the CFPB. The Senate has referred this legislation to the Committee on Banking, Housing and Urban Affairs but to date has not taken any further action.

Hearing Objective

In the year prior to the CFPB beginning operations on July 21, 2011, the staff responsible for setting up the new agency have made some important decisions that are likely to impact the Bureau for quite some time. Decisions were made on what staff to hire, what those staff members will be responsible for and how their new regulatory structure will be exercised. Given the potential impact of the CFPB, it is essential that the bureau make every effort to consider the impact that their actions will have on small businesses. This hearing will review will the regulatory priorities of the CFPB and examine what the bureau is doing to protect small businesses from overly burdensome compliance costs associated with those regulations. The Committee will also hear from small businesses to find out the impact on those that are subject to the jurisdiction of the CFPB.

[34] Pub. L. No. 111-203 § 1023.
[35] H,R. 1315, 112th Cong. (2011).
[36] *Id at. §103.*